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EXPANDED AUDITING PROCEDURES
FOR LARGE CREDIT UNIONS

by

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B.A., Augustana College, 1967

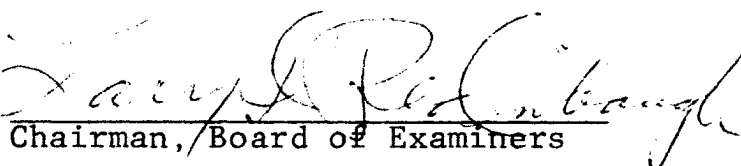
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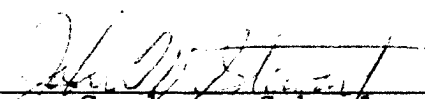
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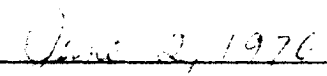
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PREFACE

The auditing of a credit union is a responsibility of the supervisory committee, a volunteer body composed of credit union members appointed by the Board of Directors. The Federal Credit Union Act directs the supervisory committee to perform at least one comprehensive audit annually and to verify the record of each member's account every two years. The Supervisory Committee Manual for Federal Credit Unions, published by the National Credit Union Administration (NCUA), an independent agency under the executive branch of the Government, provides the committee with guidelines for the performance of its functions.

As a credit union grows in size and complexity the presently established auditing system becomes inadequate and expanded auditing procedures are needed for several reasons. First, the members of the supervisory committee, being volunteers, are not usually technically skilled in the more complex techniques of auditing. Second, as volunteers, the committee members normally do not have the time required for the auditing of a large credit union.¹

¹The NCUA defines a large credit union as one having assets in excess of \$1 million. (Accounting Manual for Federal Credit Unions, Washington, D.C.: Government Printing Office, 1974, p. 1-2).

Third, expanded procedures are needed because the guidelines provided by the Supervisory Committee Manual are not adequate for certain procedures needed in the auditing of a large credit union.

A fourth reason is that the increased complexity of the operations of a large credit union, especially those utilizing electronic data processing, dictates the necessity of a more comprehensive auditing procedure and stronger internal control. Finally, if the supervisory committee chooses to utilize clerical assistance, the auditing guidelines provided are not adequately outlined.

In order to meet the increased demands of a large credit union, the supervisory committee may use clerical assistance or it may hire an outside auditing agency. This study will focus on the use of clerical assistance by the supervisory committee.

The purpose of this study is to: (1) analyze and describe the auditing procedures of a large credit union, (2) identify areas requiring expanded auditing procedures, and (3) develop auditing procedures for these areas.

The Malmstrom Federal Credit Union of Great Falls, Montana, was used as a model for this study because: (1) with assets of close to \$22 million it falls into the category of a large credit union, (2) it was readily accessible, and (3) its supervisory committee utilizes a clerical assistant.

Although credit unions may be either Federally-chartered or State-chartered, this study is limited to Federally-chartered credit unions because most of the published guidelines, including the Supervisory Committee Manual, are oriented toward credit unions with a Federal charter.

The expanded auditing procedures are limited mainly to those pertaining to the duties of a clerical assistant as procedures pertaining to an EDP system are beyond the scope of this study.

CHAPTER I

THE CREDIT UNION

Definition

A credit union is a member-owned, member-controlled, and member-oriented financial cooperative fundamentally unique from other financial institutions in that it is a non-profit entity.¹

A Federal credit union is a cooperative association organized to promote thrift and create a source of credit for the membership by pooling members' savings to make loans at reasonable interest rates. It is a corporation chartered under the Federal Credit Union Act to operate among groups having a common bond of occupation, association, or residence.²

Principles

As with most organizations, credit unions are founded on certain underlying principles. The foundation of a credit union is its membership. Section 109 of the Federal Credit Union Act states:

¹Jack Dublin, Credit Union Theory and Practice, (Detroit: Wayne State University Press, 1967), p. 135.

²National Credit Union Administration, Board of Directors Manual for Federal Credit Unions, (Washington, D.C.: Government Printing Office, 1974), p. 1.

....Federal credit union membership shall be limited to groups having a common bond of occupation or association, or to groups within a well-defined neighborhood, community, or rural district.³

Therefore, membership composed of individuals having a common bond is one of the basic principles of a credit union. Each credit union must specify its field of membership in its by-laws. To belong to a particular credit union one must come under its field of membership. Because of this principle, credit unions do not compete with each other but in unison with other types of financial institutions such as banks and savings and loan associations.

Another credit union principle is the promotion of thrift among its members. Credit unions are organized to provide a vehicle for its members to borrow and save. Being non-profit corporations, credit unions can provide these services at a relatively low cost.

Finally, a credit union is controlled by its members. The Federal Credit Union Act specifies that the credit union officials must be volunteers from the membership and as such cannot receive compensation. The effect of this principle is that the credit union will be operated in the best interests of its members, who are also its owners.

³National Credit Union Administration, The Federal Credit Union Act and Related Statutes, (Washington, D.C.: Government Printing Office, 1972), p. 6.

Organization

All Federal credit unions are functionally organized as depicted in Figure 1. Members of the board of directors and credit committee are elected by the general membership and the members of the supervisory committee are appointed by the board of directors.

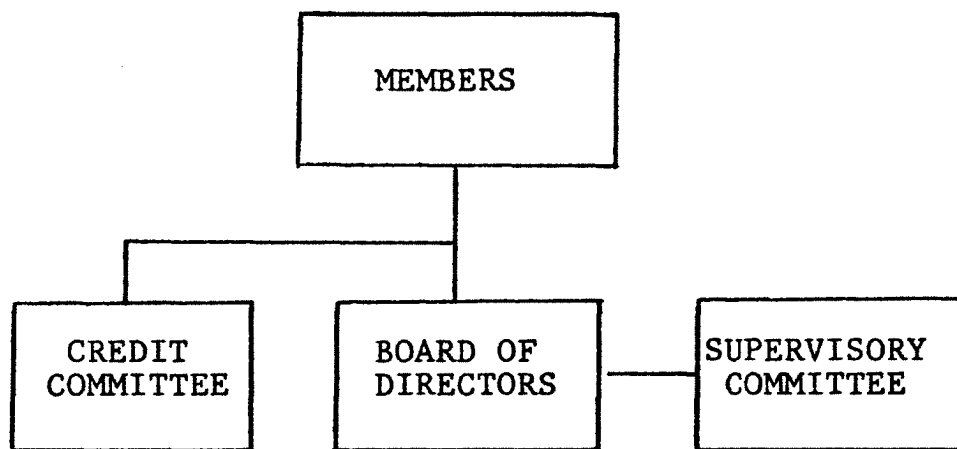


Fig. 1.--Credit Union Functional Organization

SOURCE: NCUA, Board of Directors Manual, p. 4.

Although the officials of a credit union must be volunteers, the Federal Credit Union Act does not prohibit the employment of salaried personnel to manage the day to day operations.

The operational organization of a credit union may be as shown in Figure 2. The manager, who reports to the board of directors may supervise several departments depending upon the size of the credit union. The various departments could be divided into several sub-departments. For example, the operations department could be divided into the

sub-departments of (1) tellers, (2) accounting, and (3) data processing.

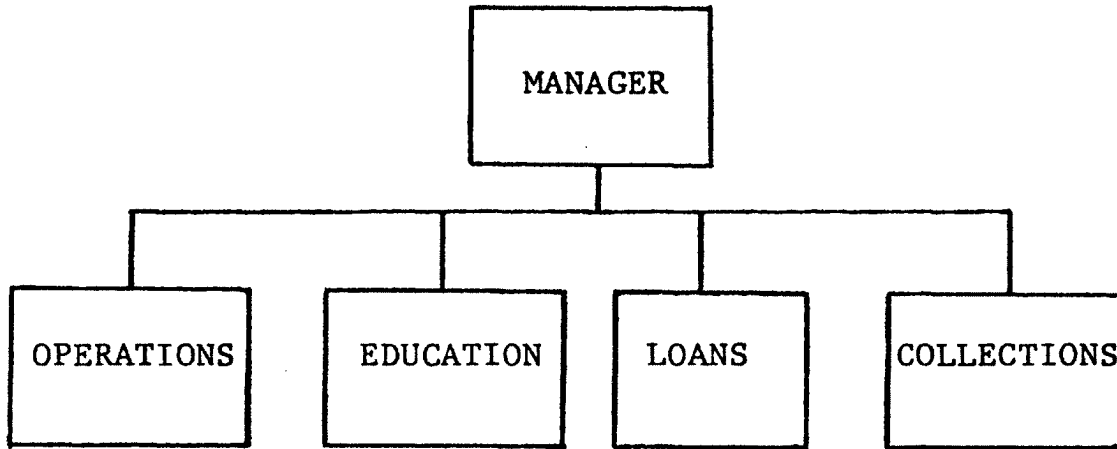


Fig. 2.--Credit Union Operational Organization

Operation

Because a credit union is a financial institution, its main commodity is money. Figure 3 illustrates the flow of money in and out of a credit union. Money comes into the credit union via (1) members' deposits, (2) loan payments, (3) interest income from investments, and (4) loans from other sources such as other credit unions. Money leaves the credit union in the form of (1) loans to members, (2) operating expenses, (3) dividend payments, (4) interest refunds, (5) savings (share) account withdrawals, (6) investments, and (7) loans to other organizations.

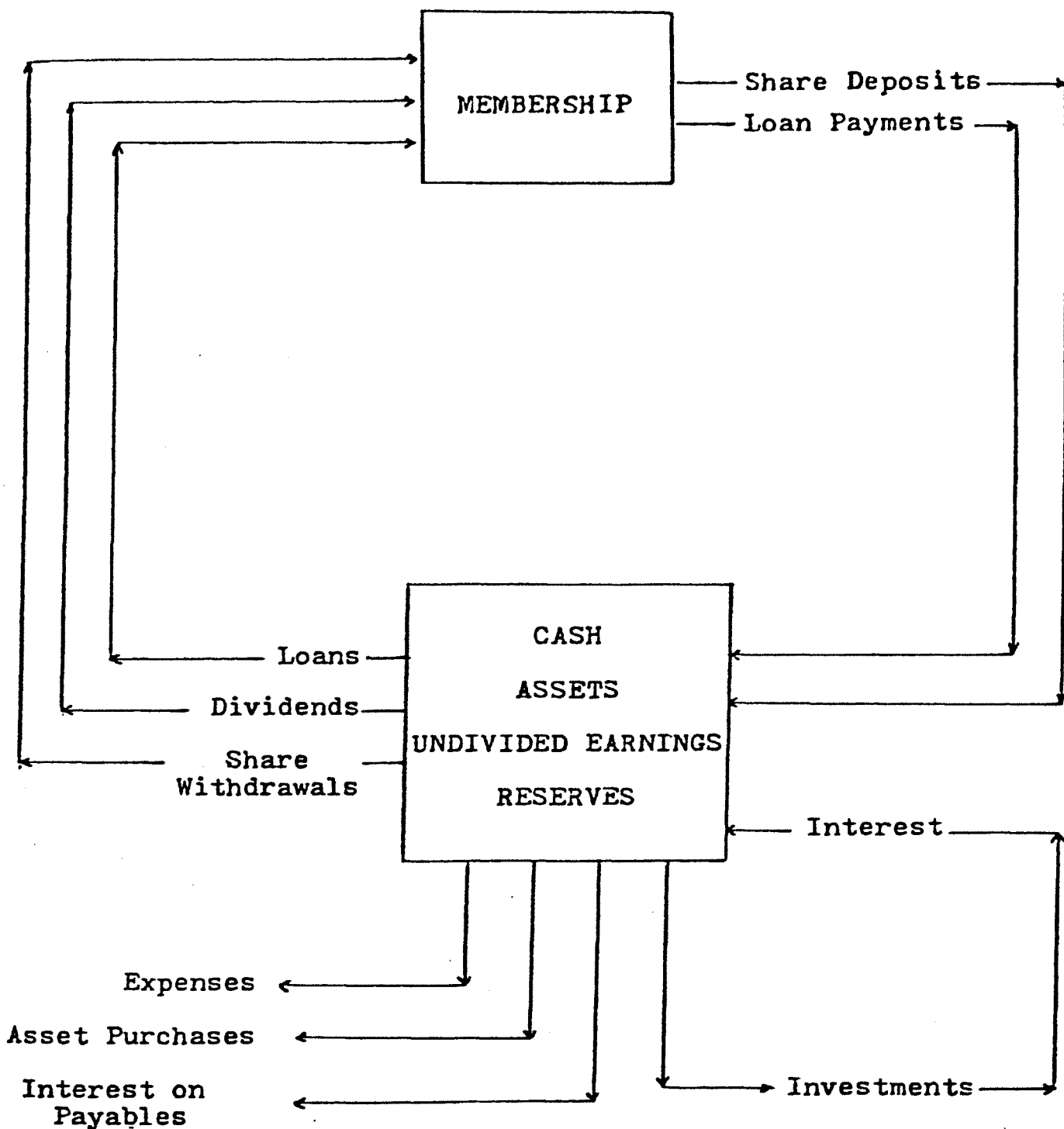


Fig. 3. Credit Union Cash Flow

The various services a credit union provides its members are established by board of directors' policy. Although a credit union's main functions are to provide members with loans and savings (share) accounts, other services may be provided such as: (1) financial counseling, (2) check cashing, (3) notary service, (4) money order and travelers check sales, (5) U.S. Government savings bond sales, and (6) credit life insurance and savings insurance.

The Board of Directors and Committees

Board of Directors

The board of directors must be composed of a minimum of five members elected by the credit union membership. It is the policy-making body of a credit union. The board's primary responsibilities include: (1) maintenance of general direction and control, (2) establishing operating policies, (3) hiring and supervising managers and staff, and (4) the appointment of supervisory committee members.⁴

Credit Committee

The credit committee must be composed of a minimum of three members elected by the general membership. It serves as the authority for the granting of loans to members. All loans made by the credit union must be approved by the credit

⁴NCUA, Board of Directors Manual, p. 4.

committee or a loan officer to whom this authority may be delegated. The primary responsibilities of the credit committee include: (1) loan granting authority, (2) appointment of loan officers, (3) counselling of members on personal financial matters, and (4) making an annual report to the members.⁵

Supervisory Committee

The supervisory committee must be composed of a minimum of three members appointed by the board of directors. It performs the internal auditing functions required by the Federal Credit Union Act as supplemented and outlined by the Supervisory Committee Manual for Federal Credit Unions. This committee's functions include: (1) making a comprehensive annual audit of the credit union, (2) verifying each member's account every two years, and (3) making a report to the board of directors and general membership annually.⁶

The Malmstrom Federal Credit Union

The Malmstrom Federal Credit Union, which was chartered in 1955, serves military and civilian personnel and their dependents at Malmstrom Air Force Base. Also included in its field of membership are military personnel serving at the various military installations throughout the State of Montana.⁷ With

⁵Ibid.

⁶Ibid.

⁷Malmstrom Federal Credit Union, Board of Directors Policy Manual.

assets in excess of \$21 million, the Malmstrom Federal Credit Union can be classified as a large credit union.⁸ It is the largest credit union in Montana.⁹ The vital statistics of Malmstrom Federal Credit Union are provided in Figure 4.

Total Assets.	\$21,669,122.61
Loans to members.	\$14,603,553.71
Shares.	\$19,421,496.51
Gross Income.	\$ 163,069.47
Total Expenses.	\$ 59,268.88
Net Income.	\$ 103,800.59
Members	18,385
Borrowers	8,909

Fig. 4.--Malmstrom FCU Statistical Information

SOURCE: Malmstrom FCU, Financial and Statistical Report for June 1975.

The Malmstrom Federal Credit Union employs over 30 full-time salaried employees as well as several part-time employees. It uses a modified cash basis of accounting and operates an in-house computer system to process the large flow of data which is generated daily.

⁸Malmstrom Federal Credit Union, Board of Directors Minutes, July 31, 1975.

⁹Montana Credit Union League, 1975 Annual Report and Yearbook.

CHAPTER II

CREDIT UNION AUDITING

Auditing

Auditing may be defined as the review and evaluation of an organization's financial records and accounting systems for the purpose of verifying the complete and accurate reporting of financial information and assisting management in its overall control of the enterprise.

The discipline of auditing may be broken down into two main areas: (1) independent auditing, and (2) internal auditing. Independent auditing focuses on the accurate reporting of financial information and operations and on the conformance with generally accepted accounting principles for the benefit of outsiders such as the federal government, owners, and creditors. Internal auditing's primary function is to evaluate the financial and accounting operations of the organization for the benefit of management.

The Supervisory Committee

The supervisory committee is the internal auditing body of a credit union. As previously stated, it is composed of volunteer members appointed by a board of directors. The Federal Credit Union Act provides a committee with the power

and authority to perform its duties and outlines its overall responsibilities. The Supervisory Committee Manual for Federal Credit Unions describes in detail these duties and responsibilities.

Section 115 of the Federal Credit Union Act specifies that the supervisory committee: (1) make an annual audit and report the findings of this audit to the members; (2) make supplemental audits as deemed necessary; (3) suspend any officer, credit committee or board member if misconduct is revealed; (4) call special membership meetings to resolve major problems; and (5) examine and verify the passbooks or account records of each member every two years.¹

According to the Supervisory Committee Manual

The primary function of the committee is to make internal audits designed to determine that: (1) accounting records and reports are prepared promptly and accurately reflect operations and their results; (2) established internal controls are effectively maintained and adequately protect the credit union, its members, its management, and its employees; and (3) each unit of the credit union is carrying out the plans, policies, and procedures for which it is responsible.

The supervisory committee also appraises policies; provides safeguards against error, carelessness and fraud; and assists management² in carrying out the purposes of the organization.

¹National Credit Union Administration, The Federal Credit Union Act and Related Statutes (Washington, D.C.: Government Printing Office, 1972), pp. 8-9.

²National Credit Union Administration, Supervisory Committee Manual for Federal Credit Unions (Washington, D.C.: Government Printing Office, 1972), p. 111.

Additional supervisory committee functions may include the objective appraisal of operations in order to protect credit union officials against unfair criticism from members or outsiders, and by providing assistance to members in resolving problems in dealing with a credit union.³ Indirectly, through its audits and internal control functions the committee has the responsibility and authority to inform the management on such areas as the nature and amount of loans, the risks of its loans, and the qualifications of its borrowers.

To carry out its duties and responsibilities the committee may perform the auditing function, employ clerical assistance, or hire outside auditing firms, as authorized under the Federal Credit Union Act. Regardless of the method used, however, the responsibility in complying with the Act remains with the supervisory committee.

The Credit Union Audit

One of the major functions of a supervisory committee is to perform a comprehensive annual audit. This function can be performed in its entirety during a single period, or parts of it can be accomplished on a periodic or routine basis throughout the year. Certain procedures of the audit require the element of surprise to be valid and effective whereas for others this requirement is not critical. The

³Ibid.

size and complexity of the credit union will usually determine the extent and timing of the audit.

The Supervisory Committee Manual specifies the following as minimum audit procedures to be performed by the supervisory committee during an annual audit:

1. Cash count.
2. General ledger trial balance.
3. Bank reconciliation.
4. Trial balance of members' ledgers.
5. Review of investments and investment transactions.
6. Review of loans to members.
7. Review of borrowing transactions.
8. Review of reserve accounts.
9. Review of undivided earnings.
10. Review of expenses.
11. Review of furniture, fixtures, and equipment.
12. Review of other asset and liability accounts.
13. Review of security devices and procedures.
14. Review of financial and statistical reports.
15. Review of surety bond and other insurance.
16. Review of board of directors minutes.
17. Review of credit committee minutes.
18. Survey of internal controls.
19. Verification of members' accounts.⁴

In conducting an audit the committee's primary emphasis is on possible defalcations, internal controls, and the financial condition of the credit union. Reports of its findings are made to the board of directors, members, and if requested, to NCUA. To assist the committee in the performance of an

⁴Ibid., pp. 109-110.

audit and the making of its reports the Supervisory Committee Manual contains various sample work papers and checklists as listed below:

1. Comprehensive Annual Audit Report, FCU 701.⁵
2. Cash Count, FCU 703.
3. General Ledger Trial Balance, FCU 704.
4. Trial Balances of Individual Share and Loan Ledgers, FCU 705.
5. Bank Reconcilement, FCU 706.
6. Loan Exceptions, FCU 707.
7. Audit Scope, FCU 709.
8. Confirmation Letter - Bank, FCU 710.
9. Confirmation Letter - Savings and Loan Association, FCU 711.
10. Confirmation Letter - Loans to Other Credit Unions, FCU 712.
11. List of Members' Accounts and Record of Verifications, FCU 713.
12. Internal Control Check List, FCU 714.
13. Reserves and Undivided Earnings, FCU 715.
14. Charged-Off Loans and Recoveries, FCU 716.
15. Gross Test Interest on Loans and Interest Refunds, FCU 717.
16. Confirmation Letter - Notes Payable, FCU 718.
17. Confirmation Letter - Certificates of Indebtedness, FCU 719.
18. Confirmation Letter - Common Trust Investments, FCU 720.
19. Confirmation Letter - Investments in Other Credit Unions, FCU 721.
20. Financial and Statistical Report, FCU 109.⁶

⁵FCU 701, FCU 703, etc., are Federal Credit Union form numbers.

⁶NCUA, Supervisory Committee Manual, p. 110.

Additional sources of assistance to a committee may include state credit union league personnel, supervisory examiners, various materials published by the NCUA, and training sessions conducted periodically by different credit union organizations.

Supplementing a supervisory committee's annual audit is the annual supervisory examination by NCUA. The purposes of this examination are:

...(1) to determine the extent of compliance with applicable laws, regulations, and sound credit union operations; (2) assist in strengthening credit union management; (3) determine the solvency of the credit union and to see that necessary steps are taken to strengthen its financial condition; and (4) determine the condition of the credit union for share insurance purposes.

In 1972 a major change was made on the emphasis of the supervisory examinations directing more attention toward the work of a supervisory committee, rather than stressing the performance of additional auditing procedures by examiners.⁸ This shift in emphasis will be discussed further in Chapter III.

The second major auditing function of a supervisory committee is the verification of members' accounts. The Federal Credit Union Act requires that a committee perform this function on all members' accounts every two years, and further recommends that it be done annually.

⁷Ibid., p. 114.

⁸William B. Covington, "Spotlight on Supervisory Committees," NCUA Quarterly Spring 1974, p. 18.

This procedure entails the comparison of a member's records of transactions with the records of the credit union. Its purpose is to verify the accuracy of a credit union's records, to protect a member's interests, and to prevent or detect fraudulent practices.⁹

⁹NCUA, Supervisory Committee Manual, p. 141.

CHAPTER III

THE NEED FOR EXPANDED AUDITING PROCEDURES

Approximately 38 percent of all Federal credit unions use outside auditing assistance for all or a portion of a supervisory committee audit.¹ This percentage when applied to the number of FCU's in existence today would indicate that out of the 12,922 Federal credit unions, 4,910 of these FCU's utilize outside auditing assistance.² Why is this so? Why would a credit union spend a sizable amount of money for professional auditing assistance when the supervisory committee could do the job free of charge?

One possible explanation could be that the guidelines and procedures provided for the use of supervisory committees are inadequate. More detailed or expanded procedures may be necessary to enable the committee to perform its own audits. In fact, there are five major reasons why expanded auditing procedures are necessary: (1) increased NCUA emphasis, (2) credit union size, (3) credit union complexity, (4) inadequate guidelines, and (5) supervisory committee limitations.

¹William B. Covington, "NCUA's Commitment to Supervisory Committees," NCUA Quarterly, Spring 1973, p. 16.

²"Monthly Credit Union Trends," Credit Union Research Bulletin, No. 170, April, 1975, p. 3.

NCUA Emphasis

An often cited statement in credit union circles is, "Supervisory Committees are the weakest link in the chain in the credit union."³ Whether true or not for all credit unions, this statement points out an area of major concern for many credit union officials. In 1972, NCUA made a major conceptual change in its approach to conducting supervisory examinations. Instead of conducting its own annual audits on credit unions, the NCUA examiners are now focusing attention on the supervisory committees. At the beginning of each supervisory examination the NCUA examiners are meeting with supervisory committees, reviewing the committee's latest audit report and work papers, and analyzing these to determine how well a supervisory committee is doing its job. If uncompleted procedures or weak areas are found, the examiners either assist a committee in completing an audit, or help strengthen weak points through training sessions.⁴

Therefore, in response to the charge that supervisory committees are a credit union's "weakest link," expanded auditing procedures could be developed and implemented to strengthen this link.

³William B. Covington, "NCUA's Commitment," NCUA Quarterly, Spring, 1973, p. 16.

⁴Ibid.

Credit Union Size

As a credit union increases in size, the volume of its transactions may increase, additional services may be offered, delinquent and charged-off loans may increase, payrolls may become larger, and pension plans may become involved. The use of sampling techniques may be employed to cope with these larger numbers but the development and use of samples requires increased expertise, a quality that may be lacking in most supervisory committees. Also, the task of account verification cannot be reduced through sampling procedures because of the requirement that all members' accounts must be verified every two years. This audit procedure alone would become a formidable task for a committee of a large credit union. For instance, for a credit union the size of Malmstrom Federal Credit Union with approximately 18,000 members, the supervisory committee has to verify at least 9,000 accounts each year. In a case such as this expanded procedures could be developed to alleviate some of the workload of the committee.

Credit Union Complexity

In addition to increased size, large credit unions are also accompanied by increased complexity. Factors that may add to a credit union's complexity are: (1) computerized data processing systems, (2) more complex accounting systems such as accrual accounting, and (3) more involved investment

transactions. To a supervisory committee, increased complexity means that more detailed auditing procedures and stronger internal controls are needed.

Inadequate Guidelines

The Supervisory Committee Manual for Federal Credit Unions is a supervisory committee's "bible." This manual provides the committee with detailed instructions and samples of audit work papers for many of the audit procedures used by the committee for its audits. In this manual, however, the NCUA admits that the procedures outlined are only minimal. For small credit unions the Supervisory Committee Manual may be adequate, but for large credit unions, especially those utilizing electronic data processing systems, it is not. Certain auditing procedures which will be discussed in later chapters, either are not covered by the manual, or if covered, are not explained in sufficient detail to be of any significant aid to the committee.

There are several other sources of assistance for a supervisory committee, such as consultants employed by the credit union leagues, correspondence courses published by various credit union organizations, The NCUA examiners, local CPA firms, and various auditing textbooks or other auditing publications. But the volunteer committee members cannot be expected to conduct extensive research in developing procedures for which it has no guidelines.

Supervisory Committee Limitations

The fact that supervisory committee members must be volunteers imposes three limitations on the committee's effectiveness. First, as volunteers from the general membership, the committee members are not usually skilled in the field of auditing. As "lay" personnel, then, from an auditing viewpoint, these people would not, in most cases, have any formal training in auditing. Supervisory committee members, therefore, have to rely on the guidelines and assistance available to them in order to understand their duties. The existence of expanded auditing procedures would help the members better understand how to do their function.

Second, the auditing of a large credit union takes more time in the area of account verification. Again, as volunteers, the committee members probably do not have the time required to adequately attend to the demands of auditing a large credit union. More detailed instructions on certain phases of the auditing function could help alleviate this problem by providing a means for a committee to increase its efficiency.

A third factor limiting the effectiveness of a committee is the turnover rate of its members. This turnover rate may be particularly high for committees composed of military members, such as in the case of the Malmstrom Federal Credit Union. Also, this turnover rate may be increased due to the frustrations involved for the committee members when trying

to do a relatively complex job with limited guidelines and assistance. The availability of expanded guidelines could have two possible effects on this problem. For one, with the aid of better and more detailed auditing procedures, the retraining of new committee personnel would be easier. Also, if the guidelines were improved the committee's frustrations could possibly be reduced, which could in turn decrease the rate of turnover of committee members.

Alternatives

As previously mentioned, a supervisory committee has the option of doing the audit, hiring clerical assistance, hiring outside professional auditors, or some combination of the three. By the use of expanded auditing procedures a committee could perform more of the auditing tasks on its own and reduce its reliance on outside help.

The remainder of this study will be addressed to the auditing of a large credit union by a supervisory committee utilizing clerical assistance with the aid of expanded auditing procedures.

CHAPTER IV

AUDITING WITH CLERICAL ASSISTANCE

To relieve itself of the burden of performing many routine auditing tasks, the supervisory committee may hire clerical assistance. This clerical assistance can be either paid or unpaid, full-time or part-time. For the authority to expend a credit union's funds for assistance, the committee needs to obtain the board of directors' approval. Although many of its auditing tasks can be accomplished by the assistant, the supervisory committee is still responsible for the audit as well as the selection, training, and supervision of the assistant. According to the Supervisory Committee Manual:

The committee will normally confine the duties of the assistant to the more detailed phase of the audits. The more complex phases of the audits, such as the evaluation of audit findings and preparation of reports, should be performed by the committee members.¹

The main effect of utilizing clerical assistance is the separation of routine from non-routine functions. With the duties separated in such a manner, a committee can concentrate on major auditing tasks and on special problems or

¹NCUA, Supervisory Committee Manual, p. 113.

situations. Clerical assistants can perform routine test checks, bank statement reconciliations, account verifications, and maintain the records of the committee. A sample position description for a clerical assistant is presented in Appendix A.

Advantages

For the supervisory committee of a large credit union, there are several advantages in using clerical assistance. The most obvious advantage, a reduced workload for a committee, has already been discussed.

A second advantage is the improvement in the quality of the audit. Samples for routine test checks can be larger and taken more frequently, which may result in an increased probability of finding discrepancies. These findings, in turn will provide for an earlier correction of errors and therefore, a more immediate feedback to the supervisory committee and management.

Third, the utilization of clerical assistants could result in stronger internal controls. The mere presence of auditing personnel at a credit union on a daily basis, continually performing routine test checks such as surprise cash counts, could induce greater care and accuracy on the part of the credit union staff in the performance of its duties. Also, any weaknesses in internal controls may be detected earlier and corrected more promptly.

Fourth, member-credit union relations may be improved.

One of the responsibilities and duties of a supervisory committee is to serve as the members' representative. When members find discrepancies or have questions, they are referred to the supervisory committee for assistance. With a full-time clerical assistant at a credit union, members with questions can be attended to on a walk-in basis by the assistant.

Fifth, by having a major portion of the routine audit steps accomplished by an assistant, the length of the annual audit can be shortened. Additionally, an assistant can aid a committee during an audit by performing such clerical tasks as locating information and typing reports.

A sixth advantage of using clerical assistance is to improve member account verification. With a large credit union such as Malmstrom Federal Credit Union, member turnover is relatively high. This often results in an increased workload for a supervisory committee in updating its records and verifying the members' accounts. A clerical assistant can do this on a continuous basis.

Another advantage is that a higher degree of committee continuity can be maintained when clerical assistance is used. For credit unions serving defense installations where committee members are likely to be military personnel, the turnover rate of the committee members may be quite high. The presence of a clerical assistant will, in these cases, add to the stability of the committee and provide an added degree of continuity.

And finally, the use of clerical assistants could be a valuable aid to management. The assistant, being at the credit union daily, can detect inefficiencies and unfavorable trends in the credit union's operations, thereby enabling a committee to make recommendations for improvements.

Disadvantages

There are two major disadvantages that the supervisory committee must consider when employing clerical assistance. One of these is cost. The cost of using clerical assistance must be weighed against both the ability of the credit union to afford such an expense and also against the benefits to be gained. For large credit unions, some type of assistance for a supervisory committee is almost a necessity. In these cases, the costs and benefits of clerical assistance versus professional auditors must be considered.

The second major disadvantage of using clerical assistance is the tendency of a supervisory committee to rely too heavily on the assistant. Over-reliance by a committee on the clerical assistant could result in a weakening of the committee members' auditing knowledge and skills. The supervisory committee can avoid this danger by constantly keeping in mind that it maintains overall responsibility for its functions regardless of what type of assistance is used.

CHAPTER V

EXPANDED ACCOUNT VERIFICATION PROCEDURES

The Development of Expanded Auditing Procedures

Using the Malmstrom Federal Credit Union as a model, the following areas are identified as requiring expanded auditing procedures:

1. Verification of new accounts.
2. Verification of dormant accounts.
3. Verification of closed accounts.
4. Review of Credit Committee minutes.
5. Review of current loans.
6. Review of share pledged loans.
7. Review of delinquent loans.
8. Reconciliation of travelers checks.
9. Verification of insurance claim payments.
10. Review of payroll.

In selecting the procedures to be expanded, those contained in the Supervisory Committee Manual were reviewed and classified according to the amount of routine work involved in each procedure. Of those involving large or time-consuming workloads, the procedures or guidelines available either in the Supervisory Committee Manual or other sources, were reviewed for adequacy of explanation and detail.

Those procedures which were determined to have inadequate guidelines were reviewed from an internal control standpoint.

The procedures found to be highly repetitive and time-consuming, inadequately explained, and involved in an area of weak internal controls, were considered to be of primary importance, and in need for expanded auditing procedures. Conversely, those procedures covering a low volume of transactions, of adequate explanation, and in areas of strong internal controls were not expanded.

Expanded Account Verification Procedures

The importance of the account verification procedure is evidenced by the fact that an entire section (Section IV) of the Supervisory Committee Manual is devoted to its explanation. In Federally chartered credit unions, each account has to be verified every two years with a one-year cycle being the recommended frequency. For State-chartered credit unions, each account has to be verified once each year. There are several methods or procedures which may be used in account verification, depending upon the types of records used, i.e., passbooks, or statements of account. Since the Malmstrom Federal Credit Union uses the statements of account system, this method will be discussed in the following pages.

The Supervisory Committee Manual defines the procedure of verification as "an act by the committee to compare each member's records of his transactions with the credit

unions' records of these same transactions."¹ The manual goes on to summarize the purposes of account verification as:

1. To obtain independent evidence as to the completeness and accuracy of the credit union records insofar as they pertain to members' accounts.
2. To demonstrate to the members that efforts are being made by the supervisory committee to protect their interests.
3. To deter and detect dishonesty on the part of the officials and employees of the credit union should such occur.²

When statements of account are used, two methods of verification can be used. These are either positive or negative verification. For both methods, the balances of the members' accounts are recorded on a form and sent directly to the members by the supervisory committee. Under the positive verification method, a member is asked to reply whether or not the records agree. Under the negative verification method, a member need reply only if a discrepancy is noted, in a verification of the statement of account.

In lieu of the above two methods, a supervisory committee may control the distribution of the statements to the members. This procedure is a form of negative verification whereby a member is asked to reply to the committee should there be a discrepancy. This procedure is explained in detail in the Supervisory Committee Manual and it is the system in use by the Malmstrom Federal Credit Union.

¹NCUA, Supervisory Committee Manual, p. 141.

²Ibid.

This system of account verification is used to verify the balances of active accounts. There are several other types of accounts which require verification. There are new accounts, dormant accounts, and closed accounts. As the Supervisory Committee Manual does not explain the steps involved in verifying these types of accounts, the remainder of this chapter will present expanded procedures for these areas.

New Accounts

Audit Procedure. Listing of New and Reopened Accounts.

Purpose. To update a Supervisory Committee's records by recording all new, and reopened accounts, in the List of Member's Accounts, and Record of Verification, and to verify that there are no account numbers missing.

Frequency of Accomplishment. Once each month or as required.

Period Covered. Not applicable.

Scope. One hundred percent of all new and reopened accounts.

Materials Required.

1. New Account Report
2. List of Member's Account and Record of Verification.

Work Papers. General Audit Work Papers. (See Figure 4)

Audit Steps.

1. New Accounts. From the New Account Report, list the following information in the List of Member's Accounts and Record of Verification:
 - a. Account number
 - b. Name
 - c. Date account opened.

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SUPERVISORY COMMITTEE
GENERAL AUDIT WORK PAPER

AUDIT PROCEDURE:

DISCREPANCY:

ACTION TAKEN:

REMARKS:

Supervisory Committee

Date

Fig. 5. Sample General Audit Work Paper

2. For reopened accounts. In the List of Member's Accounts:
 - a. Find the name and account number of the member.
 - b. Remove the outdated information on this member (cover with correction tape).
 - c. Enter new opened date.
3. Screen New Account Report to determine if any new account members are missing.
4. Compare first new account number on New Account Report with last account number in List of Member's Accounts and verify that no account numbers are missing.
5. If account numbers are missing or other discrepancies are noted:
 - a. Attempt to determine reason for discrepancy from credit union staff.
 - b. Record discrepancy and action taken on General Audit Work Paper.

Dormant Accounts

Audit Procedure. Verification of Activity in Dormant Accounts.

Purpose. To verify that any withdrawals from dormant accounts are only by authorized individuals.

Frequency. Once each month.

Period Covered. Previous month.

Scope. One hundred percent of dormant accounts showing activity.

Materials Required.

1. Posted Error Listing.
2. Check vouchers.
3. Cash withdrawal vouchers.
4. Journal vouchers.
5. Closed Account Reports.
6. Application for Membership cards.

Work Papers.

1. Posted Error Listing.
2. General Audit Work Paper.

Audit Steps.

1. On the Posted Error Listing, the "Error Message" column will specify either "Activity on Dormant Account" or "Dormant Account Closed." The Transaction Code column will list one of the following codes:
 - a. Code "A": Cash or check deposit.
 - b. Code "O": Account closed.
 - c. Code "Q": Cash withdrawal.
 - d. Code "R": Withdrawal by check.
 - e. Code "S": Withdrawal by journal voucher transfer.
2. Code "A" transactions. Annotate "Deposit" on appropriate line on Posted Error Listing. No further action is required.
3. Code "O" transactions. Spot check with Closed Account Report to verify the account appears on that report. No further action is required as positive verification is made on all closed accounts.
4. Code "Q" transactions.
 - a. Crosscheck the following on the Posted Error Listing with the information on the applicable cash withdrawal voucher:
 - (1) account number
 - (2) name
 - (3) amount
 - (4) date.
 - b. On Posted Error Listing on appropriate line annotate "cash" to signify that a proper cash voucher was present and annotate member's name on the same line.
 - c. Verify authenticity of member's signature on cash withdrawal voucher against signature on member's Application for Membership card.

5. Code "R" transactions.

- a. Crosscheck the following on the Posted Error Listing with the information on the check voucher:
 - (1) account number
 - (2) name
 - (3) amount
 - (4) date.
- b. On the Posted Error Listing annotate the check number and member's name to signify the presence of a check voucher.
- c. Verify authenticity of member's signature on check voucher against member's Application for Membership card.
- d. If withdrawal was requested by mail, the letter of request should be attached to the check voucher.
 - (1) Verify that a letter is attached to check voucher.
 - (2) Verify authenticity of member's signature on letter of request against signature on member's Application for Membership card.

6. Code "S" transactions.

- a. Crosscheck the following on the Posted Error Listing against the journal voucher:
 - (1) account number
 - (2) name
 - (3) amount
 - (4) date.
- b. On the Posted Error Listing annotate:
 - (1) Account number of account funds were transferred to.
 - (2) Member's name.
 - (3) Purpose of transfer, i.e., transfer to another account, loan payment, or account closed.
- c. Verify member's signature on journal voucher or attached letter against signature on member's Application for Membership card.

7. For discrepancies noted:
 - a. Attempt to determine reason from credit union staff.
 - b. Annotate the discrepancy and action taken on General Audit Work Paper.

Closed Accounts

Audit Procedure. Positive Verification of Closed Accounts.

Purpose. To verify that the proper individual has closed the account and received the money; to verify that the proper amount was received by the member; to verify that the credit union's records have been properly annotated; and to update the Supervisory Committee's confidential record of members' accounts.

Frequency. Once each month.

Period Covered. Previous month.

Scope. One hundred percent of all accounts closed during the period except for delinquent and charged-off loan accounts that have been closed by the credit union.

Materials Required.

1. Check vouchers
2. Positive Verification Cards
3. Current Closed Account Report
4. Journal vouchers
5. Cash withdrawal vouchers
6. Current Share and Loan Journal
7. List of Member's Accounts and Record of Verification.
8. Current Address Listing.

Work Papers.

1. Closed Account Work Paper. (See Figure 6)
2. Positive Verification Cards.

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AUDIT WORK PAPERS

Audit Procedure: Review of Closed Accounts.

Accounts closed during the month of: _____.

Accounts closed (list account numbers):

Total number of accounts closed: _____.

Accounts with Discrepancies: (list and attach General Audit
Work Paper)

Supervisory Committee

Date

Fig. 6. Sample Closed Account Work Paper

Audit Steps.

1. Screen all check vouchers from previous month to find those disbursed for the purpose of closing an account. (Vouchers should be annotated as such.)
2. From the check voucher, post the following information to the Positive Verification Card:
 - a. account number
 - b. name
 - c. date
 - d. amount
 - e. voucher check number.
3. Address verification card with address obtained for current Address Listing.
4. Screen all cash withdrawal vouchers from previous month to find those indicating the closing of an account.
5. Repeat steps 2 and 3 above.
6. Crosscheck all completed verification cards with:
 - a. The current Share and Loan Journal to verify that the accounts have been closed (zero balances) and not reopened.
 - b. The current Closed Account Report to verify that the closed accounts appear on the report.
7. Screen the Closed Account Report to verify all accounts listed have a positive verification card prepared.
 - a. For accounts appearing on report but not listed on a card:
 - (1) Crosscheck against journal vouchers using the date as reference and verify that a voucher was properly prepared.
 - (2) Crosscheck against Share and Loan Journal to verify that the accounts have been annotated as closed (zero balances).
 - (3) Post information to verification cards as in steps 2 and 3.

- b. For accounts having a verification card but not posted on the Closed Account Report:
 - (1) Annotate the discrepancy on the General Audit Work Paper.
 - (2) Notify credit union staff of the discrepancy.
 - (3) Follow up to verify that the discrepancy has been resolved.
8. From the completed positive verification cards list all account numbers on the Closed Account Work Paper.
9. Annotate the date and that the account was closed on the List of Member's Accounts and Record of Verification (for proper annotating procedures refer to the Supervisory Committee Manual, page 153).
10. Mail the verification cards to the members.
11. When the cards are returned by the members annotate the fact on the List of Member's Accounts and Record of Verification.
12. Crosscheck the return address with the address on the current Address Listing and update the listing if necessary.
13. Reconcile any discrepancies reported by the member with the member and credit union staff.
14. Record discrepancies and actions taken on the General Audit Work Paper.
15. File returned verification cards until the next Statements of Account are mailed out to the members.

By using these procedures in conjunction with the account verification procedures outlined in the Supervisory Committee Manual, a supervisory committee can improve the quality of its audits. Also, when these procedures are used on a continuing basis by a clerical assistant, the workload of a supervisory committee during an audit can be reduced considerably.

CHAPTER VI

EXPANDED LOAN VERIFICATION PROCEDURES

A major function of a supervisory committee is to review outstanding loans. The National Credit Union Administration recommends that a committee review a minimum of ten percent of the outstanding loans annually. The recommendation is specified in the Supervisory Committee Manual as follows:

Total loans reviewed should include at least 10% of loans granted since previous audit and a sufficient number of loans to indicate proper recognition of delinquency classification.¹

For a credit union the size of Malmstrom Federal Credit Union which grants approximately 12,000 loans annually, this minimum requirement means the supervisory committee should review at least 1,200 loans each year.² This is an area in which clerical assistance is definitely a must for credit unions of this size, or larger.

The function of reviewing outstanding loans can be separated into four general areas.

1. Review of Credit Committee Minutes.
2. Review of current loans.

¹NCUA, Supervisory Committee Manual, p. 137.

²Malmstrom Federal Credit Union, 20th Annual Report, 1974.

3. Review of share pledge loans.
4. Review of delinquent loans.

Credit Committee Minutes

Audit Procedure. Review of Credit Committee Minutes.

Purpose. To verify that loans are approved within legal limits and board policy, and that the credit committee minutes are properly completed and signed, and to obtain loan data for subsequent loan verifications.

Frequency. Once each month.

Period Covered. Previous month's minutes.

Scope. One hundred percent of minutes.

Materials Required. Credit Committee Minutes.

Work Papers. Review of Credit Committee Minutes Audit Work Paper. (See Figure 7)

Audit Steps. (See Appendix B for detailed discussion on sampling procedures.)

1. Review minutes for proper dating, completion, and signature by credit committee and loan officer.
2. On audit work papers, list the following for all loans selected for review:
 - a. account number
 - b. name
 - c. date
 - d. loan amount.
3. On Share Pledge Loan Audit Work Paper (See Figure 8) list the following for all share pledge loans:
 - a. name
 - b. account number
 - c. amount of loan
 - d. date
 - e. amount of shares pledged.
4. Record any discrepancies found and bring it to the attention of the credit union staff.

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SUPERVISORY COMMITTEE AUDIT WORK PAPERS
REVIEW OF CREDIT COMMITTEE MINUTES

For the month of: _____

LOANS REVIEWED:

<u>ACCT#</u>	<u>NAME</u>	<u>DATE</u>	<u>AMOUNT</u>
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DISCREPANCIES:

ACTION TAKEN:

Supervisory Committee

Date

Fig. 7. Sample Credit Committee Minutes Audit Work Paper

MALMSTROM FEDERAL CREDIT UNION
 SUPERVISORY COMMITTEE
 AUDIT WORK PAPERS

Audit Procedure: Review of Share Pledge Loans

For the month of: _____

SHARE PLEDGE LOANS:

<u>ACCOUNT</u>	<u>NAME</u>	<u>DATE</u>	<u>AMOUNT OF LOAN</u>	<u>AMOUNT PLEGGED</u>
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DISCREPANCIES:

ACTION TAKEN:

 Supervisory Committee

 Date

Fig. 8. Sample Share Pledge Loan Audit Work Paper

Current Loans

Audit Procedure. Review of Current Outstanding Loans.

Purpose. To verify that all loans granted are within legal limitations and board policy, and that all the required documentation has been properly completed, dated, and signed.

Frequency. Once each month.

Period Covered. Outstanding loans issued during month three months previous to current month.

Scope. Review a minimum of 10 percent of all loans issued during the subject month.

Materials Required.

1. Credit Committee Minutes Audit Work Paper.
2. Loan files.

Work Papers. Loan Exceptions Report.

Audit Steps.

1. Obtain audit work papers for the credit committee minutes pertaining to the month three months previous to the current month. (The loans of this month are reviewed as all documentation should have been completed and filed in the loan file by this time.)
2. Obtain loans files listed on work papers.
3. Review each loan file for the following:
 - a. Date - the latest loan contained in the file should be for the applicable month. If a later loan has been obtained, discontinue the review of this file as it will come up for review during a later month. Enter on the Loan Exception Report "New Loan" and enter the date of the new loan.
 - b. Loan File Check Sheet - verify that all items checked are contained in the file. Review the reverse side for any significant information, i.e., delinquency.

- c. Permanent Record - verify that the front is adequately completed and that the latest loan has been entered on the reverse side.
- d. Loan Application - verify that a purpose for the loan has been listed and that the applicant has signed the form. Verify that the reverse side has been completed and approved by a loan officer or the credit committee.
- e. Promissory Note -
 - (1) Verify the numerical figures and long-hand numbers agree.
 - (2) Verify that the amounts and number of payments agree with those listed on the Credit Disclosure Form.
 - (3) Verify that the proper interest rate has been charged in accordance with board policy for that type of loan.
 - (4) Review the security listed and verify that the description and serial numbers agree with those on the lien and security agreement. If furniture, personal items or household goods were used as collateral, verify that a Financing Statement has been completed and filed with the State.
 - (5) Verify that the promissory note has been signed, dated, and witnessed.
- f. Security Agreement - verify that this form has been signed and properly completed.
- g. Credit Disclosure Statement -
 - (1) Verify that it has been signed on front (and on the reverse side if member is military on active duty).
 - (2) Verify correctness of calculations of interest charges and payment amounts.
 - (3) Verify that the correct interest rate was used.
- h. Insurance - if insurance is required on the collateral used, i.e., automobiles, trailer houses, etc., verify that the proof of insurance statement has been completed and signed.

4. Annotate any discrepancies found on the Loan Exceptions Report and submit the report to the board of directors at the next board meeting.

Share Pledge Loans

Audit Procedure. Review of Share Pledge Loans.

Purpose. To verify that the accounts which have shares pledged as collateral for a loan are frozen (cannot be withdrawn) for the total amount of the loan.

Frequency. Once each month.

Period Covered. Previous month.

Scope. One hundred percent of share pledge loans.

Materials Required.

1. Credit Committee Minutes Audit Work Paper.
2. Share and Loan Journal.
3. Loan files.

Work Papers. Share Pledge Loans Audit Work Paper (see Figure 9).

Audit Steps.

1. Crosscheck information on Share Pledge Loan Audit Work Paper with Share and Loan Journal and verify that the proper amount is reflected on the S&L as being frozen. (Signified by "F" on the S&L.) The shares of more than one account may be frozen for one loan and therefore all accounts indicated as being frozen must be so annotated.
2. If discrepancies are found:
 - a. List the discrepancies on the Audit Work Paper.
 - b. Obtain the loan file and present it to the credit union staff for corrective action.
3. Follow up in several days on any discrepancies found to verify that the appropriate amount of shares have been frozen.

Delinquent Loans

Audit Procedure. Review of Delinquent Loans.

Purpose. To verify that proper and timely actions are being taken on delinquent loans and to monitor for any significant trends resulting in delinquencies as charged-off loans.

Frequency. Once each month

Period Covered. Most current delinquent loans.

Scope. A minimum of 10 percent of the total delinquent loans. Concentrate review on loans being delinquent for one month or more.

Materials.

1. Delinquent loan file.
2. Delinquent Loan Report.

Audit Steps.

1. Obtain most recent Delinquent Loan Report.
2. Obtain delinquent loan files from collection department.
3. Compare data in loan file to report and verify that the correct account numbers are listed on the report.
4. Review loan files for evidence of collection activity.
5. Review files for possibilities of charge-offs.
6. On Delinquent Loan Report, annotate:
 - a. Latest activity.
 - b. Latest status of member, i.e., unemployed, relocated, etc.
 - c. Collection probabilities, whether collectible or doubtful.
7. Annotate any discrepancies on a General Audit Work paper.
8. Discuss status of delinquent accounts with collection department supervisor.

By continually reviewing the loan procedures of a credit union, a supervisory committee clerical assistant can recognize trends that may be developing and thereby alert management to any potential problem areas.

CHAPTER VII

OTHER EXPANDED AUDITING PROCEDURES

As credit unions grow in size, they may tend to offer more services. Although not addressed in the Supervisory Committee Manual, these activities need to be audited by the supervisory committee. The procedures developed in this chapter are applicable to the Malmstrom Federal Credit Union, however, other credit unions may have other additional services for which auditing procedures have not been developed.

The auditing procedures to be presented in this chapter include:

1. Verification of insurance claim payments.
2. Verification of travelers checks.
3. Review of Payroll.

Insurance Claim Payments

Audit Procedure. Verification of Insurance Claim Payments.

Purpose. To verify that the beneficiary or other authorized person received the deceased member's shares.

Frequency. As required.

Period Covered. Not applicable.

Scope. One hundred percent of all death claim payments.

Materials Required.

1. Insurance company letter.
2. Closed Account Report.
3. Share and Loan Journal.
4. Check vouchers.

Work Papers.

1. Insurance company letters.
2. General Audit Work Papers.

Audit Steps.

1. Review insurance company's letter for:
 - a. member's name
 - b. amount of claim
 - c. date of claim.
2. Crosscheck the amount of claim with:
 - a. Share and Loan Journal
 - b. check vouchers.
3. Send out positive verification to beneficiary.
4. Annotate action taken and date on insurance company letter.
5. For discrepancies:
 - a. Annotate General Audit Work Paper.
 - b. Discuss with credit union staff.

Travelers ChecksAudit Procedure. Verification of Travelers Checks.

Purpose. To verify that the amount of travelers checks issued and on hand agree with credit union's records, and verify that the credit union's records agree with those of the issuing company.

Frequency. Reconcile the travelers checks with the credit union's records once each month. Confirm the credit union's records with the issuing agency's records once each year.

Period Covered. Travelers checks account as of the current date.

Scope. One hundred percent of travelers checks.

Materials Required.

1. Travelers checks.
2. Travelers check ledger.

Work Papers. Travelers checks Audit Work Paper, (see Figure 9).

Audit Steps. (NOTE: This procedure must be done in the presence of a credit union employee.)

1. Count all travelers checks on hand and verify that they are in numerical sequence and that none are missing.
2. On the Travelers Checks Audit Work Paper, list by serial numbers the beginning and ending travelers checks of each denomination.
3. Add the checks of each denomination and list the total on the work paper.
4. Add the totals of all denominations to derive a grand total for the travelers checks account and list on work paper.
5. Verify these totals with the travelers check ledger.
6. Have a credit union employee sign the audit work paper to verify the crosscheck was made.
7. Annotate any discrepancies and bring them to the attention of the credit union staff.
8. Send out annually a confirmation letter to the issuing agency.

Payroll

Audit Procedure. Review of Payroll.

Purpose. To verify that the payroll records of the credit union's employees are correctly maintained; that the proper withholdings are being deducted; and that the employees are

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 SUPERVISORY COMMITTEE
 AUDIT WORK PAPERS

Audit Procedure: Verification of Travelers Checks

<u>Denomination</u>	<u>Beginning Serial No.</u>	through	<u>Ending Serial No.</u>	<u>Total Amount</u>
10's	_____		_____	_____
20's	_____		_____	_____
50's	_____		_____	_____
100's	_____		_____	_____
		Grand Total		_____

Discrepancies:

Action Taken:

Verified Correct:

 Credit Union Employee

 Supervisory Committee

 Date

Fig. 9. Sample Travelers Checks Audit Work Paper

being paid according to the level authorized by management and the board of directors.

Frequency. Once each year.

Period Covered. Payroll records since last audit.

Scope. The records of a minimum of 10 percent of the total employees on the credit union's payroll.

Materials Required.

1. Payroll checks and check stubs.
2. Employee Time and Attendance Records.
3. Employees Earnings Records.
4. Employees Withholding Allowance Certificate.
5. Authorization for Payroll Deduction.
6. State Tax Withholding Tables.
7. Federal Tax Withholding Tables.
8. Social Security Tax Withholding Tables.
9. Credit Union Pay Scale.

Work Papers. General Audit Work Papers.

Audit Steps.

1. Select a block or random sample of the payroll records of a minimum of ten percent of the employees.
2. Obtain the most recent paychecks and paycheck stub copies and crosscheck the following data to the Employees Earnings Record:
 - a. Name
 - b. Date
 - c. Gross amount
 - d. Federal tax withheld
 - e. State tax withheld
 - f. Social Security tax withheld
 - g. Credit union deductions withheld
 - h. Net amount.
3. Crossfoot the totals on the Employees Earnings Record.
4. With the information on the Employees Earnings Record:

- a. Crosscheck the pay scale and base pay amount with the credit union's pay scale.
 - b. Verify that the employee was paid for the amount of hours shown on the Employee Attendance and Time Record.
 - c. Compare the State and Federal tax withholdings to the appropriate table.
 - d. Verify that the correct amount of Social Security tax was withheld by recomputing the amount from the appropriate table.
 - e. Crosscheck any deductions made by the credit union with the Authorization for Payroll Deduction Form.
5. Verify that each employee has a W-4 form on file and that the number of exemptions listed agrees with the Employees Earnings Record.
 6. Review the past history of the employee's pay records to verify that the employee received all automatic salary increases when due.
 7. List the names of the employees whose records were audited on the General Audit Work Paper.
 8. Record any discrepancies found on the General Audit Work Paper and bring these discrepancies to the attention of the credit union management.

For large credit unions such as the Malmstrom Federal Credit Union, the monetary amounts involved in each of these areas may be substantial. The Supervisory Committee Manual, however, does not provide guidelines for the auditing of these areas and therefore these expanded procedures were developed.

CHAPTER VIII

FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

Findings

The growing size and complexity of many credit unions today presents increased challenges for supervisory committees. The growing number of transactions processed daily by credit unions places greater demands on the time of the committee members. The effects of inflation and sharpened competition requires credit unions to cut costs and curb spending wherever possible. Supervisory committees, therefore, have to operate as resourcefully and efficiently as possible.

A supervisory committee's flexibility and effectiveness are restricted, however, by several limitations. The volunteer nature of the committees poses the biggest problem. As volunteers, committee members are not likely to be adequately qualified in the more complex auditing techniques required for large credit unions. Committee turnover limits its effectiveness as experienced members are replaced with new members. Also, the auditing of a large credit union requires a considerable amount of the committee member's time, particularly in the areas of members' account

verification and loan review. Another factor affecting the demands on the time of the committee members is the legal restriction of a maximum five members on the supervisory committee.

Greater credit union complexity requires more technical knowledge of the committee members. To meet this increased complexity, the guidelines and training provided to the supervisory committees must be adequate and understandable. The present guidelines published by the NCUA, while sufficient for the smaller credit unions, have become inadequate for the larger credit unions. Several auditing procedures presented in the Supervisory Committee Manual need more detailed explanations, while other auditing procedures necessary for large credit unions are not presented at all. For these areas, the committees of large credit unions have to develop their own procedures or seek help from outside agencies.

Conclusions

To maintain effectiveness, supervisory committees of large credit unions have several alternatives. Independent auditors can be utilized, clerical assistants can be employed, committee expertise can be improved, or some combination of these alternatives can be developed. The situation of each individual committee will dictate which alternative is most desirable and feasible. The fact that the committee remains completely responsible for the satisfactory accomplishment of its duties does not change, regardless of which alternative

is chosen. To meet its responsibilities, the committee must maintain an adequate level of competency and proficiency. A committee must have adequate guidelines so that it may develop and maintain these qualities. To overcome the time and expertise limitations of the committees, the guidelines must be understandable and complete. The guidelines and procedures presently provided do not meet these requirements. Expanded procedures are needed if the supervisory committee is to be expected to live up to its responsibilities.

The expanded auditing procedures developed in this study, if implemented and utilized, can result in several benefits to the committee and the credit union regardless of whether the committee performs its own audits or uses outside help. Specifically, the procedures developed in this study have resulted in the following:

1. The guidelines available to the supervisory committee and clerical assistant have been extended to those areas not adequately presented by previously available sources.
2. Audit work papers were developed which will aid the committee in the performance of its functions.
3. With some of the auditing functions explained in more detail, the supervisory committee can better understand its duties and thereby increase its effectiveness and efficiency.
4. With the utilization of additional work papers, the audit records of the committee can be improved,

which will aid not only the committee but also the NCUA examiners.

5. The combination of improved procedures and additional work papers should result in a reduction of the duplication of effort. The committee will have a better idea of what work has been accomplished and what work remains to be done.
6. For those credit unions hiring outside professional auditors, the implementation of these expanded procedures could possibly reduce the committee's dependence on outside help and thereby reduce costs.

Recommendations

Supervisory committees of large credit unions such as the Malmstrom Federal Credit Union should consider implementing these auditing procedures. Credit union organizations such as credit union leagues and chapters should incorporate these procedures into training material for supervisory committee personnel. The National Credit Union Administration should consider adopting and incorporating these procedures in future publications of the Supervisory Committee Manual. Only by providing supervisory committees with better tools and guidelines can the credit union organization insure that its "weakest link" will not remain weak but become strong and viable.

APPENDIX A

SAMPLE POSITION DESCRIPTION FOR CLERICAL ASSISTANT

POSITION: Clerical Assistant to Supervisory Committee

SUPERVISOR: Supervisory Committee

PRIMARY FUNCTIONS: To provide clerical assistance to the supervisory committee with its auditing duties as specified by the Supervisory Committee Manual and supplemented by Board of Directors Policy.

DUTIES AND RESPONSIBILITIES:

1. Reconcile bank statements monthly.
2. Review loan files.
 - a. Test for delinquency.
 - b. Verify computations.
3. Verify closed accounts.
4. Verify activity in dormant accounts.
5. Verify insurance claim payments with beneficiaries.
6. Review Board of Directors' minutes.
7. Review Credit Committee minutes.
8. Review accounts with share pledge loans.
9. Perform positive verification of members' accounts.
10. Review expenses.
11. Record new accounts in committee's records.
12. Review delinquent accounts.
13. Attend credit committee meetings.
14. Verify travelers checks.
15. Perform cash counts.
16. Make monthly reports to the Supervisory Committee on work performed and discrepancies detected.
17. Assist credit union members with questions on accounts.
18. Perform other clerical or auditing duties as directed by the committee.

APPENDIX B

LOAN SAMPLING PROCEDURES

The Need for Loan Sampling

Ideally, every new loan should be audited by the committee to insure the best interests of both the credit union and the borrower are protected. This procedure, however, may not be practical for several reasons. If the number of loans issued is large, the cost of reviewing these loans in terms of clerical salaries or auditing agency fees may far outweigh the resulting benefits such as reduced delinquencies, charge-offs, and collection costs. Also, the time required to review the entire loan population may exceed the manhours available to perform the task.

Finally, the accuracy of each individual loan review may be decreased if a 100 percent review is attempted. If the number of loans to be reviewed is large in relation to the amount of time the committee has available for this procedure, accuracy and thoroughness may have to be sacrificed.

Through the proper use of sampling procedures the committee can still obtain its objectives and yet contain costs, reduce the time required for this procedure, and maintain the desired level of accuracy.

Sample Size

If the review of the entire loan population is impractical and the committee determines that sampling must be used, two important considerations must be addressed: the size of the sample, and the method of choosing the individual loans to be included in the sample. In general, the appropriate sample size depends on two main factors: the consequences or risks of making an error, and the costs. The smaller the sample size, the greater are the risks of not detecting errors or unfavorable trends. But at the same time, the larger the sample size, the greater will be the costs associated with that sample. There is a trade-off between risk and cost.¹

The NCUA has provided guidelines as to the minimum and maximum number of loans that should be reviewed.

1. Ten percent (10%) of outstanding loans as of the effective date of the audit with a suggested minimum of 25 loans and a maximum of 250 loans (more if necessary).
2. Review of such additional loans, if necessary, so that the total number of loans reviewed will include at least 10% of loans granted since the effective date of the previous audit
.....²

The size of the loan sample will have to be the decision of the supervisory committee of each individual

¹Lawrence L. Lapin, Statistics for Modern Business Decisions (New York: Harcourt Brace Jovanovich, Inc., 1973), p. 251.

²NCUA, Supervisory Committee Manual, p. 41.

credit union. When making this determination the following should be considered:

1. The number of loans issued by the credit union.
2. The amount of time available to the committee and the proportion of this time it wants to allocate to this task.
3. The costs of accomplishing this task.
4. The quality of the loans and accompanying paperwork. The number of errors found may indicate a need for a larger sample size. Or, if unfavorable trends are revealed such as increased delinquencies or charge-offs, the committee may want to reallocate some of its time to the review of more loans.
5. The strength of internal controls should also be considered. The stronger the internal controls, the smaller the sample size.

After the committee has arrived at what it feels is a proper sample size, it should continually monitor the results of this activity and periodically increase or decrease the sample size as circumstances dictate.

Types of Samples

In addition to finding the proper sample size, the committee should select the proper type of sample most suitable for its purposes. There are several types of samples such as: the random sample, the systematic random sample, the judgment sample, the stratified sample, and the cluster sample.

The random sample involves the choosing of a specified number of objects out of the entire available population completely by chance. Picking numbers out of a hat would be a form of random sampling. A more scientific method of choosing random samples would involve the use of a table of random numbers.

A judgment sampling sample is one obtained simply by the evaluation of the population and choosing the sample which seems to be the most representative. This type of sample may be satisfactory if the number of objects is small and if the individual selecting the sample has sufficient skill and experience. But as the number of objects increases, the effectiveness of this procedure tends to decrease.

If the population from which the sample is to be selected is composed of different homogeneous groups, a stratified random sample may be more appropriate. Instead of choosing objects at random from the entire population, a random sample would be taken from each group making up that population. Loans, for example, could be categorized according to the amount of the loan, or according to the loan purpose. From each of these categories, a random sample could be taken until the total number of loans selected meets the required sample size.

The cluster or block sample is another type of sample that could be used in selecting loans for review. Under this method a group or block of loans would be chosen, for example, the first and last one hundred loans issued during the period. From these blocks, a census or 100 percent of the loans would be reviewed.

Another variation of the random sample is the systematic random sample. The first loan to be reviewed is selected entirely at random and then every fifth, tenth, fifteenth loan,

etc., is selected at equal intervals until the proper sample size has been obtained.

The NCUA has also made recommendations on this subject in the Supervisory Committee Manual.

The committee should determine the pattern to be used in reviewing loans. A recommended method is to review every tenth loan or a similar sequence. This will insure the review of loans representing all segments of the loan portfolio. Another method is to concentrate the review in a block or blocks of loans, such as from Account No. 290 through Account No. 420. In order for this pattern to be effective, block(s) which are considered representative of the entire loan portfolio should be chosen for the review....³

The first technique recommended by NCUA is a systematic random sample and the second method is a combination of the judgment and cluster samples.

Suggested Sampling Techniques

Loans issued by credit unions can be classified into two major categories: signature loans and collateral loans. Signature loans are usually smaller in dollar amount and because collateral is not required, less paperwork is involved. The cut-off point between the two is usually a certain dollar amount established by the board of directors. The Malmstrom Federal Credit Union policy, for example, is to limit signature loans to dollar amounts less than \$2500.00. Although selected high-risk signature loans may be secured by collateral, all loans of \$2500.00 or greater require collateral unless approved otherwise by the board of directors.

³Ibid.

The review of loans by the supervisory committee could also be divided between these two major categories. This would entail the use of a stratified random sample.

This type of sampling may be the most effective for several reasons. First, collateral loans involve more money and therefore more risk as the length of the loan period may be longer and the amount of the monthly payments may be higher. As risk increases, sample size should be increased. Based on this principle, a larger sample should be taken from the collateral loans than from the signature loans.

Second, the use of collateral for a loan requires more paperwork such as security agreements, financing statements, and proof of insurance documents. This additional paperwork provides more room for clerical error such as incorrect serial numbers.

Also, if the collection of a loan or the repossession of collateral becomes necessary, the chances of success are improved by insuring proper documentation. An unsigned security agreement, incorrect serial number, or unfiled financing statement, for instance, could have a significant effect on the collection efforts.

Finally, by concentrating the loan review on collateral loans, a larger dollar amount of loans outstanding is subject to review within the same sample size.

The proportion of loans to be reviewed from each category will have to be based upon the judgment of each committee. As a starting point, a committee may want to review a census

of the collateral loans with the remainder of the sample being made up of random selections from the signature loans. Past experiences and trends should serve as guides for each committee in making this determination. For the reasons cited above, however, greater emphasis should be placed on collateral loans.

In general, a committee may want to use the following procedures in selecting its loan samples.

1. Determine proper sample size by considering:
 - a. time available
 - b. costs
 - c. internal controls
 - d. discrepancy levels
 - e. trends.
2. Allocate portions of the sample between collateral and signature loans, concentrating on collateral loans.
3. Segregate the loans from which the sample is to be taken into two categories: collateral loans and signature loans.
4. Within each category, assign a number to each loan.
5. Use a table of random numbers to select each loan to be reviewed until the predetermined sample size has been obtained.
6. Perform the loan review on the selected loans.

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